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No. 96-1189

IN THE
# Supreme Court of the United States
OCTOBER TERM 1996

BURLINGTON RESOURCES OIL & GAS COMPANY,
*Petitioner,*

*vs.*

FEDERAL ENERGY REGULATORY COMMISSION,
*Respondent.*

**Petition for a Writ of Certiorari to the United States Court of Appeals for the District of Columbia**

## REPLY BRIEF OF PETITIONER BURLINGTON RESOURCES OIL & GAS COMPANY

Kim M. Clark
*Counsel of Record*
JOHN, HENGERER & ESPOSITO
1200 17th Street, N.W.
Suite 600
Washington, D.C. 20036
(202) 429-8800

Richard M. Blumberg
Associate General Counsel
BURLINGTON RESOURCES
OIL & GAS COMPANY
5051 Westheimer
Suite 1400
Houston, Texas 77056
(713) 624-9270

*Attorneys for Petitioner*

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## PARENT COMPANIES AND NONWHOLLY OWNED SUBSIDIARIES

The statement which appeared in the Petition remains correct.

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Burlington Resources Oil & Gas Company (Burlington Resources) herewith files its reply to the Brief For The Federal Energy Regulatory Commission (FERC) in Opposition (FERC Brief). The decision below to which this Petition applies is *United Distribution Companies, et al. v. Federal Energy Regulatory Commission*, 88 F.3d 1105 (D.C. Cir. 1996). Pet. App. 1a-174a.

## ARGUMENT

At issue in this Petition is whether, under the right of first refusal (ROFR) mechanism inaugurated by FERC as part of its Order Nos. 636, *et seq.* rulemaking proceeding,[1] a natural gas pipeline company should be required to continue firm transportation service for an existing shipper who has matched the highest competitive rate and term bid for such service, even though the rate is less than the highest permissible maximum rate established by FERC (maximum rate). This situation arises where the demand for pipeline capacity is less than the supply, which is the case in the nation's largest natural gas market, California, and which may also occur in midwest and northeast markets in the near term.

An illustration best serves to explain the point before the Court (hereinafter the Example). Assume the following facts:

| | |
|---|---|
| Maximum rate | $.30/MMBtu |
| Existing shipper's current rate | $.10/MMBtu |
| Highest rate bid and matched by an existing shipper per ROFR | $.15/MMBtu |

Burlington Resources maintains that an existing shipper should be able to retain its service by paying $.15/MMBtu, but FERC asserts the pipeline company can terminate service entirely unless the existing shipper agrees to pay $.30/MMBtu. This has been termed the "no discounting rule", because the pipeline

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[1] Order No. 636, FERC Statutes and Regulations 30,939 (1992); Order No. 636-A, FERC Statutes and Regulations 30,950 (1992); *Pipeline Service Obligations, and Revisions to Regulations Governing Self-Implementing Transportations Under Part 284 of the Commission's Regulations and Regulations of Natural Gas Pipelines After Partial Wellhead Decontrol,* Order No. 636-B, 61 FERC ¶ 61,272 (1992).

company is not obligated to discount below the maximum rate. FERC Brief at 8.

## I. FORCING AN EXISTING SHIPPER UNDER THE ROFR MECHANISM TO PAY THE MAXIMUM RATE IS AN ANTI-COMPETITIVE EXERCISE OF MONOPOLY POWER AND A DENIAL OF SECTION 7(b) CONSUMER PROTECTIONS.

There is no dispute that the Natural Gas Act (NGA), 15 U.S.C. §§ 717, *et seq.*, was intended to provide consumers with the lowest reasonable rates and with continuity of service. Moreover, the enhancement of competition was at the heart of FERC's issuance of Order Nos. 636, *et seq.*[2] However, FERC's no discounting rule violates these precepts by forcing an existing shipper either to give up its firm service rights or pay a rate that is above-market.

This is a *prima facie* case of anti-competitive behavior and abuse of market power. Nevertheless, FERC defends its no discounting rule by asserting that even if the maximum rate is above-market, pipeline customers cannot be harmed by paying a FERC established maximum rate. FERC Brief at 21-2. Besides the substantial harm to existing shippers illustrated in the Example, FERC's argument fails on several other grounds.

First, FERC's reasoning completely contradicts the stated purpose of the ROFR mechanism, which is that price and term competition will determine which party gets pipeline capacity.[3] *See e.g.,* FERC's description of the ROFR as a

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[2] *See e.g.,* Pet. App. 178a-182a. FERC summarized its mission as follows:

> The Commission's primary aim in adopting the instant regulations is to improve the competitive structure of the natural gas industry and at the same time maintain an adequate and reliable service.

*Id.* at 181a.

[3] FERC claimed in Order Nos. 636, *et seq.* that the ROFR procedure would: (i) allow "the rate to play a role in rationing capacity . . . ." (Pet. App. 323a);

*(footnote continues)*

> process allowing competitive allocation of capacity at the expiration of long-term contracts for pipeline transportation...

FERC Brief at 6.

> [P]ipeline transportation is most efficiently allocated if it is sold to those willing to pay the highest price for the capacity.

*Id.* at 7.

But competition does not serve to allocate capacity where supply exceeds demand, because FERC lets the pipeline company disregard the competitive, market-determined outcome and instead force an existing shipper to pay an above-market rate or lose its service rights (*see e.g.*, the Example, *supra*). Thus, those without market power are left to be exploited by the wielder of market power, the pipeline company, and forced to pay a rate that could not be charged in a competitive environment.[4] This is a result which is patently anti-competitive and thus impermissible under the NGA.

Second, FERC seeks to support the no discounting rule by reference to this Court's decision in *Mobil Oil Exploration & Producing Southeast, Inc. v. United Distribution Companies,* 498 U.S. 211 (1991), which FERC characterizes as approving a "similar pricing mechanism". FERC Brief at 21. Although both cases involve pregranted abandonment, the comparison is not appropriate, since the orders under review in *Mobil* gave both

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*(footnote continued)*

(ii) "recognize the role of market forces in determining contract price and term" (Pet. App. 675a); and (iii) permit "the market to determine contract terms" and allow "market forces to play a significant role in determining the contract price . . . ." Pet. App. 933a.

[4] *See e.g., Jefferson Parish Hosp. Dist. No. 2 v. Hyde,* 466 U.S. 2, 27 n.46 (1984), where this Court defined market power to exist "whenever prices can be raised above the levels that would be charged in a competitive market."

parties negotiating leverage.[5] Thus, the Good Faith Negotiation procedure at issue in *Mobil* did not allow one side to inflict unilaterally the maximum rate on the other party.[6] This is not true of FERC's ROFR mechanism, where the no discounting rule permits the pipeline company to impose the maximum rate on the existing shipper or terminate that shipper's current transportation service.

Third, FERC tries to justify sanctioning monopolistic pricing practices by arguing that it cannot compel the pipeline company to charge less than the maximum rate, because the pipeline company might not recover its allocated cost of service. FERC asserts it "cannot require a pipeline to accept rates below the cost-based just and reasonable ceiling . . .", and that the maximum rate is, "by definition, the lowest rates that ensure pipelines an adequate return on their investment . . . ."[7] FERC Brief at 22.

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[5] These orders entailed the pregranted abandonment of producer sales to pipelines at "old" gas prices. In return for agreeing to pay a higher price, the pipeline was free to negotiate the reduction or elimination of its take-or-pay obligations to that producer. If, however, the parties could not agree on terms, the producer either continued service at the existing prices or found another buyer willing to pay the requested price. 498 U.S. at 219-20, 231.

[6] The Court stated in Mobil, 498 U.S. at 226, "There is nothing incompatible between the belief that a price is reasonable and the belief that it ought not be imposed without prior negotiations."

[7] FERC never offered this explanation in Order Nos. 636, *et seq.*, probably because FERC is well aware there is no mathematical relationship between the rate set and a pipeline company's actual revenues. As FERC knows, once rates are set, a pipeline company can reduce its costs of operation, increase throughput, sell more firm and interruptible services, or take other steps which will result in increased profits not contemplated at the time of the rate orders. *See* Burlington Resources Petition at 16.

Moreover, FERC's position assumes cost-based ratemaking, however FERC itself is experimenting with non-cost-based ratemaking. *See e.g., Alternatives to Traditional Cost-of-Service Ratemaking for Natural Gas Pipelines and Regulation of Negotiated Transportation Services of Natural Gas Pipelines, Statement of Policy and Request for Comments,* 74 FERC 61,076 (1996).

This logic is fatally circular and internally inconsistent. On the one hand, FERC argues it cannot compel a pipeline company to accept a below maximum rate bid under the ROFR mechanism, because that might imperil the ability of the pipeline company to recover its full cost of service. Yet, if the pipeline company leaves capacity idle rather than sell it at less than the maximum rate under the ROFR procedure,

> there is no guarantee that it will be able to recover all the costs of its underutilized capacity from its customers when it files its next rate case.

Pet. App. 936a, footnote omitted.[8] Other than the timing of FERC's action, the result is the same, the pipeline does not recover the full cost of its capacity by virtue of a FERC decision.

FERC offers no explanation why what it allegedly "cannot" do as part of the ROFR mechanism, it is free to do in the context of a pipeline rate case. Moreover, FERC is wrong in claiming it lacks authority to require a pipeline company to accept less than the maximum rate under the ROFR mechanism. Such a requirement would merely be a condition of the ROFR mechanism, like the bidding and matching procedures, all of which were designed by FERC as a means to avoid the case-by-case abandonment criteria (including a hearing) required by Section 7(b) before an existing service can be terminated.

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[8] FERC also asserts an aggrieved shipper could file a complaint under NGA Section 5, 15 U.S.C. §717d, alleging the pipeline company's action is "unjust, unreasonable, unduly discriminatory, or preferential." FERC Brief at 21 n.13. Since this is an entirely new argument, it should not be entertained; *see* FERC Brief at 15, n.10. In any event, FERC action under Section 5 has prospective effect, which provides no remedy to an existing shipper who previously had to elect either to lose its firm service or pay a rate that is above market and/or higher than its existing contract rate.

In addition, FERC's argument fails because it overlooks the purpose of Section 7(b), which is to protect service continuity and not to guarantee revenues for pipeline companies.[9] Moreover, if existing shippers who supposedly are protected by Section 7(b) can be made to pay the maximum rate regardless of their existing contract rate or how the market values pipeline capacity, new shippers—particularly captive shippers—will be completely at the mercy of the pipeline company, even where the supply of capacity exceeds the demand.

Forcing a utility customer to pay an above-market rate is an exercise of monopoly power, whether the imposed rate is FERC approved or not. FERC cites no relevant precedent to the contrary, nor does FERC succeed in justifying the anti-competitive effect and lack of customer protection inherent in the no discounting rule.[10]

In the Example noted above, the maximum rate, the existing contract rate, and the lower ROFR bid rate all are cost-based, just and reasonable, and FERC approved. Thus, the dispute before the Court, simply stated, is whether Section 7(b) should be interpreted to insure the revenues of the pipeline company, as FERC asserts, or to protect the right of an existing shipper to service continuity and reasonable rates, as Burlington Resources argues. Given that the fundamental purpose of the NGA is to protect consumers against the monopolistic practices of pipeline companies, Burlington Resources should prevail.

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[9] This Court has found the NGA to be a consumer protection statute on numerous occasions, both as to rates and continuity of service. *See* the cases cited, Burlington Resources Petition at 8-9.

[10] FERC is obligated to consider anti-trust considerations in its deliberations. *See e.g., Gulf States Utilities Co. v. FPC,* 411 U.S. 747 (1973).

## II. PRESERVATION OF THE NO DISCOUNTING RULE IS INCONSISTENT WITH FERC'S ORDER ON REMAND FROM THE DISTRICT OF COLUMBIA CIRCUIT DECISION.

The ROFR mechanism has two essential elements, the rate and the term of years bid, which the existing shipper must match in order to retain its service rights. The term of years included in Order Nos. 636, *et seq.* was a 20-year maximum, but this was remanded by the court below for further explanation. Pet. App. 53a. As noted in the FERC Brief, at 8 n.6, on remand FERC issued an order February 27, 1997 adopting a 5-year maximum contract term for ROFR purposes.[11] Burlington Resources concurs in this decision, but the change to a 5-year term fatally undermines FERC's insistence herein on the no discounting rule.

FERC's rationale for the switch from a 20-year to a 5-year contract term is that the reduced period reflects: (i) the need to recognize market forces in implementing the ROFR mechanism, [12] (ii) the need to overcome a pipeline's natural monopoly power,[13] (iii) acknowledgment of current contracting practices,[14] and (iv) the importance of not locking shippers into

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[11] Order No. 636-C, 78 FERC 61,186 (1997).

[12] Order No. 636-C, 78 FERC at 61,773.

> The right-of-first-refusal mechanism was, and is, intended to protect existing customers and provide them with the right of continued service, while at the same time recognizing the role of market forces in determining price and term.

[13] [T]he cap should protect captive customers from having to match competing bids that offer longer terms than the competing bidder would have bid "in a competitive market without pipelines' natural monopoly."

*Id.*, footnote omitted.

[14] *Id.* at 61,774. "[T]he current data lead us to conclude that the term must be significantly shorter than the twenty-year cap approved in Order No. 636."

long-term contract arrangements they do not want.[15] If these same factors relied on by FERC with respect to the term element of the ROFR mechanism were applied with equal force to the rate element, the no discounting rule would be overturned.

Since the original 20-year ROFR term has been judged by FERC to be excessive because it condemns pipeline customers to the abuses of monopoly power, the same logic dictates existing shippers should not be forced to pay an above-market rate. Moreover, shortening the maximum contract term to five years from twenty years dramatically reduces the pipeline company's exposure to possible cost underrecovery if the pipeline company were required to accept the highest rate bid and matched (but less than the maximum) in the ROFR process, as Burlington Resources advocates.[16]

The need to coordinate the rate and term aspect of the ROFR mechanism is particularly acute as a result of the changes wrought by Order Nos. 636, *et seq.,* since pipeline companies are not obligated to file rate cases at a time certain, and they increasingly enter into long-term rate settlements, sometimes of up to ten years.[17] These circumstances effectively isolate the pipeline company from rate scrutiny for extended periods, thereby lessening into nothingness FERC's argument that a pipeline company might suffer in its next rate case for deliberately idled capacity.

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[15] FERC concluded its 5-year contract term would "avoid customers' being locked into long-term arrangements with pipelines that they do not really want . . . ." Id.

[16] The reverse, however, is not true, because no utility customer should have to pay an excessive, monopoly initiated rate for any period. Moreover, shortening the contract term does not eliminate the exercise of pipeline monopoly power, and reducing the contract term without eliminating the no discounting rule merely condemns a long-term customer to agreeing to excessive rates at more frequent intervals.

[17] Several pipelines have entered into 5-10 year rate settlements which address the treatment of idled capacity. *See e.g., El Paso Natural Gas Co.,* 79 FERC ¶ 61,028 (1997); *Tennessee Gas Pipeline Co.,* 77 FERC ¶ 61,083 (1996); *Transwestern Pipeline Co.,* 72 FERC ¶ 61,085 (1995).

## CONCLUSION

The petition for writ of certiorari should be granted.

Respectfully submitted,

KIM M. CLARK
*Counsel of Record*
JOHN, HENGERER
& ESPOSITO
1200 17th Street, N.W.
Suite 600
Washington, D.C. 20036
(202) 429-8800

RICHARD M.
BLUMBERG
Associate General
Counsel
BURLINGTON
RESOURCES OIL &
GAS COMPANY
5051 Westheimer
Suite 1400
Houston, Texas 77056
(713) 624-9270

*Attorneys for Petitioner*